

# Taxes and International Competitiveness

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## Summary

The term “international competitiveness” has long been an important part of tax policy debates and most recently has been prominent in discussions about fundamental U.S. tax reform. For example, in Executive Order 13369, President Bush stated that one goal of reform should be to “strengthen the competitiveness of the United States in the global market place.” And in July 2007, the U.S. Treasury Department hosted a conference on business tax policy to explore ways in which the U.S. tax system might be reformed to enhance competitiveness. Yet despite its prominent use, the meaning of “competitiveness” is often vague, with its definition frequently depending on the perspective of the user. This report looks at competitiveness from three different perspectives: that of individual domestic firms, that of multinational corporations, and that of domestic labor. In each case, the report then applies economic analysis to the competitiveness concept, which adds clarity by identifying the specific ways in which taxes affect international trade and investment. With trade, tax burdens can affect what is traded, its overall level, and who benefits from trade, but they do not directly affect the trade balance. Further, it is the pattern of relative U.S. taxes within the domestic economy that matters for trade, not how a firm’s taxes compare with those of its foreign competitors. With investment, taxes can affect the extent to which U.S. firms establish operations abroad and can affect economic efficiency and welfare as well as the distribution of income within the domestic economy and between the United States and foreign countries. This report was originally written by David L. Brumbaugh, Specialist in Public Finance. It explains basic economic principles and will not be updated.

## Taxes and International Trade: Competitiveness from the Individual Firm's Perspective

One perspective on competitiveness is that of the individual U.S. firm with exclusively domestic operations. For such a firm, the focus of competitiveness is trade. The company and its components—its owners, managers, employees, and perhaps even the community in which it is situated—likely define competitiveness as the firm's ability to compete for market share against imports from abroad or to compete with foreign firms in overseas export markets. From this perspective, the impact of taxes on competitiveness likely seems straightforward: taxes are an item of cost, and so how the U.S. firm's own taxes compare with those of its foreign competitors likely appears to be of critical importance. And from the firm's perspective, targeted tax relief probably seems an obvious way to improve the firm's competitive position. For example, foreign governments may appear to be subsidizing the U.S. firm's foreign competitors; consequently, a tax benefit for exports or perhaps a tax credit or accelerated depreciation allowance may seem like useful ways to "level the playing field."<sup>1</sup>

The focus here is on trade, but although economic theory agrees that taxes can affect trade, they do so in ways that are frequently at odds with the results that may seem intuitive at the firm level. The reason for the diverging views is differences in perspective: economics points out that the impact of particular tax policies reverberates throughout the economy, causing adjustments that offset effects that may seem obvious at the firm level. As a result, to see the impact of taxes on trade accurately, the perspective must move beyond that of the individual firm to that of the economy as a whole.

In shifting to the economic perspective, we look first at the economy's trade balance, perhaps what is popularly viewed as how U.S. firms in the aggregate fare against their foreign competitors. Here, the economic conclusion appears almost counterintuitive: taxes on export income or on import-competing goods have no direct bearing on the balance of trade.<sup>2</sup> The reason is exchange-rate adjustments, which act to neutralize the impact of tax policies targeted at trade. An example may prove helpful. Suppose a country implements a tax benefit for exporting that is designed to offset foreign subsidies, real or perceived. Economics indicates that if foreign consumers are to buy more of the exports, they will require more of the domestic currency (i.e., dollars). The increased demand will drive up the exchange rate, making dollars more expensive for foreign buyers. The increased price of dollars will make exports more expensive for foreign buyers and imports of foreign goods less expensive for domestic buyers. Some or all of any initial expansion in exports will be offset by the adjustments, and imports will expand. After the adjustments, there will have been no change in the country's trade balance.

In short, taxes on trade do not directly affect the trade balance. Although this conclusion may seem counter intuition, its explanation is more easily understood when we look at the nature of the trade balance itself. An economy's trade balance—either a deficit or a surplus—is simply the amount by which the goods and services a country uses differs from the amount of goods and services it actually produces. A trade deficit is the excess of a country's current use of goods and services over what it produces; a trade surplus is the value of its production minus the value of

<sup>1</sup> For an example of this perspective, see U.S. Congress, House, Committee on Small Business, *The WTO's Challenge to FSC/ETI Rules and the Effects on America's Small Business Owners*, hearing, 108<sup>th</sup> Cong., 1<sup>st</sup> sess., May 14, 2003 (Washington: GPO, 2003), pp. 17-18.

<sup>2</sup> This sets aside the impact tax revenues may have on the trade balance through their effect on the government's budget deficit. For example, a tax cut that reduces government revenue may increase the budget deficit, placing upward pressure on real interest rates. The higher interest rates, in turn, may attract greater inflows of foreign capital. The exchange rate adjustments that result may increase the trade deficit.

what it keeps for itself. The intuition is this: just as an individual cannot consume more than he earns in a given period unless he borrows, a country cannot run a trade deficit unless it, in effect, borrows by importing capital from foreign countries to finance the difference.

A country's trade balance, in short, is mirrored by its balance on capital account. For example, a country's trade deficit is necessarily mirrored by the excess of its imports of investment over investment outflows. Thus, the capital- and current-account balances move in lock-step; the trade balance can change only if capital flows change at the same time. Under the particular institutional framework of the current international economy, flexible exchange rates maintain the relation between the trade balance (the "current account") and the investment balance (the "balance on capital account"). In short, if a tax cut does not change the balance on capital account, the trade balance does not change.

If taxes do not affect the trade balance, what is their impact? Standard economic analysis relies on one of the basic foundations of international trade theory: Ricardo's theory of comparative advantage. Without presenting a comprehensive treatment of the theory, its essence holds that countries trade, in effect, in order to specialize in the production of those goods and services they produce most efficiently. Thus, it is the economy's own internal pattern of costs that matter rather than how its overall cost of production compares with those of foreign economies.

According to the theory of comparative advantage, taxes do not alter the *balance* of trade, but they can potentially alter the *composition* of trade. For example, if a country's taxes apply unevenly across its various industries, they will likely alter the particular mix of products the country imports and exports. Building on the above illustration where a tax credit or accelerated depreciation is targeted at an industry threatened by foreign competition, this analysis indicates that the targeted industry may well see its exports or import-competing sales increase as the targeted tax benefit alters the pattern of relative costs across the economy. At the same time, the international position of that country's less favored industries will decline as a part of the impact of taxes on the mix of goods that are exported and imported.

Economic analysis also indicates that tax policy towards trade can alter how economic welfare is distributed *within* the economy. For example, a targeted tax benefit designed to boost the competitiveness of one sector may in the short run benefit the owners and employees of the favored sector; at the same time, however, it will likely reduce economic welfare in sectors of the economy that do not receive the benefit. Again, however, economics emphasizes an economy-wide perspective. Here, it generally concludes that a tax policy that applies unevenly across sectors of the economy distorts the allocation of resources and diverts them from their most productive uses. Thus, although an uneven tax policy may produce "winners" in some sectors and "losers" in others, on balance the economy registers a reduction in economic welfare because of the reduction in economic efficiency. An uneven, distorting tax policy that is meant to improve trade performance likely means that the economy will specialize in the production of items it is not particularly good at making, to the detriment of overall economic welfare.

According to trade theory, each country that is a partner to trade obtains benefits from that trade; trading partners are not competing such that one country's gain is the other's loss. Rather, there are mutual gains from trade because trade allows countries to specialize in activities they do best and trade for products they make less efficiently. Under certain conditions, tax policy can alter how the gains from trade are shared among countries, but in ways that are, again, counterintuitive. For example, to the extent that an export subsidy is passed on to foreign consumers as lower prices, the subsidy shifts economic welfare from the subsidizing country to the foreign consumers of its exports. (In economic parlance, the subsidizing country's "terms of trade" are worsened.) Or, if a country has market power such that the burden of taxes on some goods is borne by foreign consumers, a judiciously applied tax policy could improve the terms of

trade. However, even setting aside the international legality of such a policy and the possibility of retaliation, identifying the product areas where this might occur is problematic.

## Taxes and Overseas Investment: Competitiveness and Multinational Corporations

Another perspective on competitiveness is that of a U.S. multinational corporation—a firm that is based in the United States but that has production facilities abroad (what economists term “foreign direct investment”).<sup>3</sup> Such a firm likely defines competitiveness as the ability of its overseas operations to compete for market share with firms from foreign host countries or firms from third countries. With respect to taxes, the firm is likely to focus on how its own taxes compare with those of its foreign competitors. From this perspective, a policy that helps competitiveness is one that reduces the multinationals’ taxes vis-a-vis foreign firms; multinationals have traditionally argued that a policy that exempts foreign operations from home-country (i.e., U.S.) tax ensures that U.S. multinationals are not at a competitive disadvantage with foreign firms.

The focus of this view of competitiveness is investment rather than trade. As with trade, however, economic theory’s conclusions about the impact of taxes on investment differs from that of the firm. Economics agrees that home-country taxes can affect the attractiveness of overseas investment, and thus alter the extent to which U.S. firms undertake foreign direct investment. According to theory, however, the important comparison is not how foreign firms’ taxes compare with those of the U.S. multinationals. Instead, the crucial comparison is between taxes on overseas investment—both U.S. taxes and any foreign taxes that apply—and the U.S. tax burden that would apply to alternative investment in the domestic economy. Where taxes on overseas investment are lower than taxes on domestic investment, firms undertake more foreign investment than they otherwise would; hence, this tax policy increases foreign investment. Where taxes on foreign investment are high, foreign investment is discouraged, and where taxes are the same in either location, tax policy does not alter the extent of foreign investment.

Theory acknowledges that a home-country exemption for foreign income may well maximize the competitiveness of the home country’s multinationals. Again, however, economics indicates that a broader perspective produces different results. First, theory holds that, if left to their own devices, profit-maximizing firms will employ their investments in the most productive locations possible—a result that maximizes the economic welfare produced by the investment. Taxes, in turn, will not distort firms’ investment decisions if tax burdens on domestic and foreign investment are equal. In short, although a tax exemption for foreign investment might maximize the competitive position of the home country’s multinationals, a tax policy that equalizes tax burdens at home and abroad maximizes world economic welfare. In contrast, an exemption policy—one that maximizes multinational competitiveness—would likely distort the location of investment, resulting in more investment where foreign taxes are lower than taxes in the United States, and lower investment when foreign taxes are higher. The economics literature has developed labels for the different policies, as follows: “competitive neutrality,” or “capital import neutrality,” is an exemption policy that maximizes the competitive position of a country’s firms; “capital export neutrality” is a policy that produces equal tax burdens at home and abroad and that

<sup>3</sup> For an example of this perspective, see U.S. Congress, Senate, Committee on Finance, *An Examination of U.S. Tax Policy and Its Effect on the International Competitiveness of U.S.-Owned Foreign Operations*, hearing, 108<sup>th</sup> Cong., 1<sup>st</sup> sess., July 15, 2003 (Washington: GPO, 2003), p. 59.

(as a result) maximizes world economic welfare because investment flows to its most efficient global location.

Economics also concludes that the perspective of multinationals' home country may differ from that of the foreign host countries. World economic welfare—that is, the welfare of the home and foreign countries combined—is maximized when capital is allocated to its most productive location. But if a country is capital-rich, as is the United States, the capital exporting country's economic welfare is maximized when tax policy to some extent discourages overseas investment. In such cases, foreign labor bears part of the burden of the export-discouraging tax, and policy increases the tax-inclusive return to the foreign investment that does occur. (Countries with less capital lack sufficient market power to pass on the burden of their taxes.) A tax policy of this nature, termed “national neutrality,” would apply a higher tax burden to foreign operations than to domestic investment, thus damping the flow of capital abroad. As discussed further below, although a policy of national neutrality maximizes the capital exporting country's welfare, it also alters the division of income between capital and labor, shifting income towards labor and away from capital. Because national neutrality distorts the location of investment, it produces an inefficient “deadweight” reduction in world economic welfare.

It is beyond the scope of this report to describe how current U.S. tax policy affects foreign investment. Here, we simply note that U.S. policy varies widely, depending on the situation of the investing firm and the particular country where investment occurs. Different features of the system are consistent with different principles. For example, the ability of U.S. multinationals to in some cases indefinitely defer U.S. tax on foreign income is consistent with competitive neutrality. Other provisions (e.g., the foreign tax credit and Subpart F's limit of deferral) are consistent with capital export neutrality. The foreign tax credit itself is limited, however, a feature consistent with national neutrality.

## International Taxation and Employment: Labor's Perspective

A third perspective on competitiveness is that of domestic labor in general.<sup>4</sup> As described in the first section's discussion of competitiveness from the individual firm's perspective, an individual firm's employees are likely to share concerns about trade with the firm's other “stakeholders.” Like the firm's owners and managers, a trading firm's employees are likely to define competitiveness in trade as the firm's ability to compete against foreign firms in export markets or in markets within the United States. Labor's policy prescriptions are likely to be in accord with those of the firm's owners: targeted tax relief.

In contrast, labor's perspective on competitiveness and international investment generally diverges from that of a multinational firm's owners. Rather than viewing itself as being in competition with foreign multinationals (as U.S. multinationals often do), domestic labor frequently views the competition as being between investment sites; labor tends to view competitiveness as the ability of the United States to compete with foreign countries as a location for what it views as job-creating business investment. The tax policy prescription that results is in accordance with this view: domestic labor has tended to support tax policies that act to discourage overseas investment, in some cases supporting tax measures explicitly designed to penalize “runaway plants”—broadly, plants that shut down operations in the United States and shift production abroad.

<sup>4</sup> For an example of this perspective, see the testimony of AFL-CIO official Thea Lea, in U.S. Congress, House, Committee on Small Business, *The WTO's Challenge to FSC/ETI Rules and the Effects on America's Small Business Owners*, p. 15.

What does economic theory say about labor and international investment? Here again, theory reaches certain conclusions that counter intuition. First, economic analysis is skeptical about the ability of international investment flows to affect the total level of employment in economy. In the short run, the closure of a domestic factory and its movement abroad will doubtless cause unemployment in the closed factory's location. In the long run, however, the economy tends to absorb much of the labor released when a firm shuts down or simply goes out of business. The economy as a whole, moreover, always has a certain amount of such transitional unemployment that occurs when firms alter their operations by, for example, shutting down operations in one location and moving to another, either at home or abroad.

The economic change behind such transitional employment is the result of a variety of factors, ranging from technological progress, to exogenous shocks, to changes in institutional policies. Theory suggests, however, that a permanent policy of discouraging the movement of U.S. firms abroad would not appreciably alter the economy's overall level of employment; economists generally believe that monetary and fiscal policy are the most effective methods of addressing spikes in unemployment, and that adjustment assistance is the most effective policy prescription for short-run, local job loss.

Although investment flows do not alter aggregate employment, theory does indicate that capital flows do affect the distribution of incomes within the domestic economy; this result was briefly noted in the previous section's discussion of national neutrality. The shift occurs because labor is more productive the more capital it has to work with. As a result, wages are generally higher and labor receives a larger share of income (and capital a smaller share) the higher is the domestic economy's capital/labor ratio. Thus, it is not surprising that labor views the flow of capital abroad with distrust, notwithstanding its tendency to see its results in terms of their impact on employment.

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